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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, APRIL 27, 1998

APPLICATION OF

VIRGINIA NATURAL GAS, INC.

CASE NO. PUE960227

For an expedited increase  
in gas rates

FINAL ORDER

On September 25, 1996, Virginia Natural Gas, Inc. ("VNG" or "the Company") filed an application for an expedited increase in rates. The Company's application proposed to increase VNG's rates by additional gross annual revenues of \$13,899,092, based upon adjusted operating and financial data for the twelve months ended June 30, 1996.

The Commission entered an Order on October 11, 1996, permitting VNG's proposed rates and tariff revisions to take effect, on an interim basis, subject to refund with interest, for service rendered on and after October 25, 1996. By Order dated October 24, 1996, the Commission assigned a Hearing Examiner to the matter, established a procedural schedule, and set the matter for hearing on April 10, 1997.

The parties to the proceeding and Staff filed simultaneous briefs on June 2, 1997.

On July 28, 1997, the Company filed a "Motion to Reduce Interim Rates in Effect Subject to Refund", wherein it sought to reduce its interim rates by approximately \$5 million until the Commission rendered its final decision in the case. The Chief Hearing Examiner granted VNG's motion to reduce rates in her Ruling of August 22, 1997. The interim reduction was made effective with the billing month of October 1997, when the quarterly billing factor adjustment took effect in order to avoid multiple rate changes.

The Chief Hearing Examiner issued her report in this matter on February 26, 1998. Based upon the evidence received, the Examiner found that:

1. The use of a test year ending June 30, 1996, is proper in this proceeding;
2. The Company's test year operating revenues, after all adjustments, were \$164,521,865;
3. The Company's test year operating deductions, after all adjustments, were \$144,606,092;
4. The Company's test year operating income and adjusted operating income, after all adjustments, were \$19,915,773 and \$19,187,065, respectively;
5. The Company's adjusted test period rate base, updated to December 31, 1996, is \$257,085,996;
6. The Company's current rates produced a return on adjusted rate base of 7.46% and a return on equity of 7.66%;
7. The Company's cost of equity is within a range of 10.40% to 11.40%, and rates

should be established at the midpoint of that range, 10.90%;

8. The Company's overall cost of capital is 9.24%;

9. The Company's current rates are unjust and unreasonable because they will generate a return on rate base less than 9.24%;

10. The Company requires an increase in gross annual revenues of \$7,241,782 to earn a 9.24% return on rate base;

11. The Company should file permanent rates designed to produce the additional revenues found reasonable herein effective October 25, 1996, to be consistent with Staff's revenue apportionment as modified herein;

12. The Company should file revised tariff sheets to incorporate Staff witness Frassetta's recommended changes;

13. The Company should be required to refund, with interest, all revenues collected under interim rates in excess of the amount found just and reasonable herein; and

14. VNG should incorporate Staff's recommendations in the cost of service study presented in the next rate case.

The Chief Examiner recommended that the Commission enter an order adopting the findings in her report, increasing the Company's authorized gross annual revenues by \$7,241,782, and directing the refund with interest of all amounts collected under the interim rates in excess of the rate level found just and reasonable by the Chief Examiner.

Comments on the Hearing Examiner's Report were filed by VNG; the Division of Consumer Counsel, Office of the Attorney General

("the Attorney General"); and a group of Industrial Protestants.<sup>1</sup> VNG filed Comments objecting to the Hearing Examiner's recommended disallowance of joint advertising expenses and a 10.9% return on common equity. The Company urged the Commission to adopt the other recommendations of the Hearing Examiner's Report.

The Industrial Protestants filed Comments wherein they urged the Commission to reject the Hearing Examiner's recommended revenue apportionment and to utilize the revenue apportionment percentages approved by the Commission in Case No. PUE920031, VNG's most recent general rate case. The Attorney General's Comments requested that the Commission adopt the Hearing Examiner's Report in its entirety.

Having considered the record, the Hearing Examiner's Report, and the Comments thereon, the Commission is of the opinion and finds that the findings and recommendations of the Hearing Examiner should be adopted, as modified and supplemented by this Order.

#### Joint Advertising Expenses

In its Comments, the Company urged the Commission to include in its cost of service the jurisdictional portion of advertising expenses related to its Energy Efficient Home ("EEH") and Qualified Gas Contractor ("QGC") programs. Based on the record

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<sup>1</sup> The Industrial Protestants appeared collectively and include Ford Motor Company; Nabisco Brands, Inc.; Owens-Brockway Glass Container, Inc.; and U.S. Gypsum Company.

herein, we conclude that VNG's advertising expenses for the EEH and QGC programs do not comply with the requirements of § 56-235.2 of the Code of Virginia or our Rules Governing Utility Promotional Allowances adopted in Case No. PUE900070. The advertisements associated with these programs are not required by "law or rule or regulation" nor do they "solely promote the public interest, conservation or more efficient use of energy; . . ." As we noted in our 1992 Order adopting Rules Governing Utility Promotional Allowances,

The Virginia Code prohibits rate recovery for electric utilities for advertising unless it is required by 'law or rule or regulation, or for advertisements which solely promote the public interest, conservation or more efficient use of energy . . .' Virginia Code § 56-235.2. Accordingly, the Commission has allowed reasonable levels of advertising expenses associated with CLM. Such practice will continue, but we will more closely scrutinize those costs in the context of individual rate cases, to carefully distinguish between advertising for cost effective CLM programs and those primarily designed to promote load growth which do not otherwise serve the overall public interest. State law does not currently address advertising by gas companies, but we have historically applied the same standards there.<sup>2</sup>

While Rule III.A.2 of our Rules Governing Utility Promotional Allowances permits a utility to advertise jointly with others, it also incorporates the statutory requirements of § 56-235.2 of the Code of Virginia into the rule by reference to that statute.

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<sup>2</sup> Commonwealth of Virginia, At the relation of the State Corporation Commission, Ex Parte: In re, Investigation of Conservation and Load Management Programs, Case No. PUE900070, 1992 S.C.C. Ann. Rept. 261, 264.

These advertisements do not satisfy the requirements of § 56-235.2 of the Code of Virginia in that they do not solely promote the public interest, conservation or more efficient use of energy.

Review of the advertising offered as typical of the EEH and QGC programs indicates that these advertisements are targeted at new potential natural gas loads and provide little information about efficiency or gas conservation. See Appendix A, pages 15-17 of Ex. LCM-22. For example, VNG's joint advertisement for Walnut Hill Estates (Appendix A, page 15 of Ex. LCM-22) identifies VNG as providing promotional assistance for the ad and contains the tag line that "[n]atural [g]as [h]omes are naturally energy efficient, economical and comfortable." The advertisement also offers a free washer and dryer to anyone who purchases a home before February 29th. The efficiencies of these free appliances are not mentioned. The plain thrust of the advertisement is to increase the Company's natural gas load, not to "solely" promote the public interest, conservation, or more efficient use of energy.

This and other VNG advertisements offered as typical advertisements for the EEH and QGC Programs do not apprise the public about how natural gas can be conserved or what specific energy efficient measures existing homeowners may undertake to conserve their gas usage. We decline to include the expenses associated with these advertisements in VNG's cost of service.

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### Miscellaneous Accounting and Depreciation Issues

Our review of the record indicates that there are certain accounting and depreciation related recommendations made by the Staff which were not rebutted by the Company and were not specifically discussed in the Chief Hearing Examiner's Report. The first such accounting recommendation involves the capitalization of property taxes relating to Construction Work in Progress ("CWIP"). We find that VNG should begin capitalizing the portion of property taxes relating to CWIP, beginning with the calendar year, 1997.

Staff has also recommended that the Commission direct the Company to file a depreciation study with the Division of Energy Regulation before VNG files its next rate case. We agree with Staff that it is appropriate to evaluate the depreciation rate for the portion of the joint use pipeline attributable to the PT-1 customers. Accordingly, we direct VNG to file a study with the Division of Energy Regulation before the Company files its next rate case.

### Return on Equity

VNG's Comments object to the adoption of the 10.9% return on equity recommended by the Staff. The Company complains that the Staff calculation of return on equity does not take into account the distortion inherent in the Discounted Cash Flow ("DCF") methodology when market prices of utility stocks are substantially above book value. It objects to the application of

a financial risk adjustment to the proxy group's return on equity because of the higher equity ratio of VNG's corporate parent Consolidated Natural Gas Company ("CNG"). VNG maintains that the Staff and, in turn, the Chief Hearing Examiner ignored the effects of lower debt cost resulting from CNG's thicker equity component. It asserts that if CNG's equity ratio is adjusted downward, CNG's cost of debt must be adjusted upward.

The range of 10.40% to 11.40%, with a midpoint of 10.90%, recommended by the Chief Hearing Examiner, is supported by the record. While all methodologies used to estimate the cost of equity have strengths and weaknesses, we do not find that the use of the DCF methodology in concert with the other methodologies supporting the 10.90% midpoint within the range recommended by the Chief Hearing Examiner resulted in an unreasonable estimate of VNG's cost of equity.

Moreover, we are unpersuaded by the Company's arguments regarding the propriety of a financial risk adjustment. Such an adjustment is necessary to reflect the lower financial risk resulting from CNG's significantly larger than average equity ratio.<sup>3</sup>

In this case, the Chief Hearing Examiner accepted Staff's recommended return on equity range which adjusts the range derived for the Staff's proxy group to recognize that CNG's

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<sup>3</sup> All of the cost of capital witnesses in this case made their recommendations based on a ratemaking capital structure for CNG, VNG's parent. Because VNG relies on its parent to supply all of its external capital needs, use of a CNG ratemaking capital structure is appropriate.

consolidated equity ratio is higher than the proxy group's equity ratio. The theory underlying such an adjustment is simple. Debt magnifies the variability of a public utility's earnings which, by definition, increases financial risk. Due to CNG's higher equity ratio and lower debt ratio, the financial risk embodied in CNG's capital structure is comparatively lower than that found in the proxy group. The higher leveraged, higher risk cost of equity estimate derived from Staff's proxy group must be adjusted downward to reflect that of a gas distribution company having a significantly lower level of leverage and financial risk embodied in CNG's capital structure. No accompanying adjustment must be made to the cost of debt because the cost of CNG's debt is its actual embedded cost. This actual cost of debt, of course, already reflects the level of equity and risk in CNG's capital structure.

#### Revenue Apportionment

The Industrial Protestants request that we reject the Chief Hearing Examiner's recommended revenue apportionment and utilize the revenue apportionment percentages approved in Case No. PUE920031, VNG's most recent general rate case. They assert that the Chief Hearing Examiner's recommendations do not satisfy the Commission's policies regarding revenue apportionment. They maintain that in an expedited rate case, the Commission should not depart from the apportionment approved in a utility's preceding general rate case.

In this proceeding, only the Staff and the Company offered cost of service studies. Unlike VNG's proposed revenue apportionment, Staff's proposed apportionment did not include increases in the revenue requirement for Rate Schedule 8 and 9 target margins. The Staff allocated VNG's requested additional revenue increase of \$13,899,092 to VNG's firm rate classes, i.e., Schedules 1 through 7, and to Schedules 9A, 11 and 12. Staff attempted to move the target margins for Rate Schedules 8 and 9 back toward the system rate of return. Resetting of the Schedule 8 and 9 target margins resulted in the Staff reapportioning \$794,101, an amount not considered in the Company's revenue apportionment proposals, to firm customers, assuming VNG received the entire amount of its requested increase of \$13,899,092. In order to assure that all firm customer classes moved toward parity, Staff apportioned most of the additional proposed revenue increase to Schedules 1 and 2, i.e., \$10,763,578 and \$2,630,000 respectively, and \$309,140 to Schedule 7. Exhibit GGF-2 to Ex. GGF-28.

During the proceeding, the Company accepted Staff's revenue apportionment and cost of service studies. The Chief Hearing Examiner generally agreed with the Staff's cost of service studies and apportionment recommendations, but was troubled by the movement away from parity these recommendations created.

When the Company revised its interim rates in October, 1997, to reduce its refund liability, it reduced rates for Schedule 1,

2, and 9A and did not modify interim rates for the remaining schedules. Consequently, interim rates currently in effect reflect the lower of the Company's or the Staff's proposed increases for each class. These interim rates produce movements toward parity for all classes, with the exception of Schedules 11 and 12. While the Staff's proposed increases for these two schedules would produce positive movements toward parity, we are concerned that the resulting return for Schedule 12 produced by the Staff's proposed increase moves too far.

Based on the foregoing, we have developed a revised revenue apportionment based on the class increases produced by the interim rates currently in effect, modified to reflect the Staff's proposed increase for Schedule 11 and fifty percent of the Staff's proposed increase for Schedule 12. This revenue

apportionment will produce an overall increase in revenues of \$8,723,066 and must be adjusted downward to reflect our finding of an overall revenue increase of \$7,241,782. Consequently, we have reduced the above revenue distribution on a pro-rata basis, as follows:

<u>Rate Schedule</u>	<u>Present Revenue</u>	<u>Revised Apportionment</u>	<u>% of Overall Increase</u>	<u>Pro-rata Reduction</u>	<u>Adjusted Increase</u>
1	\$114,795,225	\$6,828,983	78.286%	\$1,159,645	\$5,669,338
2	\$39,491,570	\$1,668,611	19.129%	\$283,351	\$1,385,260
3	\$9,850	\$1,282	0.015%	\$218	\$1,064
4	\$9,574	\$1,535	0.018%	\$261	\$1,274
5	\$13,182	\$2,777	0.032%	\$472	\$2,305
6	\$1,872,014	\$94,237	1.080%	\$16,003	\$78,234
7	\$1,664,126	\$109,009	1.250%	\$18,511	\$90,498
8	\$809,041	\$-	0.000%	\$-	\$-
9A	\$358,696	\$12,346	0.142%	\$2,097	\$10,249
9B	\$790,360	\$-	0.000%	\$-	\$-
9C	\$734,907	\$-	0.000%	\$-	\$-
9D	\$348,165	\$-	0.000%	\$-	\$-
11	\$21,365	\$3,976	0.046%	\$675	\$3,301
12	\$1,722	\$310	0.004%	\$53	\$257
<u>Increase</u>		\$8,723,066			\$7,241,782

We believe that the foregoing distribution of the increase in revenues is consistent with the principles articulated in previous Commission decisions regarding revenue apportionment in that it will produce a movement toward parity for all classes. The cost of service studies made a part of the record in this case provide a cost relationship for the revenue apportionment accepted herein. These studies represent only estimates of cost of service and not absolute indications of cost.

Finally, the Commission's Rules Governing Utility Rate Increase Applications and Annual Informational Filings adopted in

Case No. PUE850022,<sup>4</sup> do not limit the issues Staff and Protestants may raise in an expedited proceeding.<sup>5</sup> Protestants and Staff may develop issues of concern to them in the context of an expedited rate proceeding, including alternative methods to apportion revenue.

Accordingly, IT IS ORDERED THAT:

(1) The findings and recommendations of the Hearing Examiner's February 26, 1998, report, as modified and supplemented herein, are accepted.

(2) The Company shall be granted an increase in gross annual revenues of \$7,241,782, effective for service rendered on and after October 25, 1996.

(3) VNG shall forthwith file revised schedules of rates and charges and revised terms and conditions of service, consistent with the findings herein, effective for service rendered on and after October 25, 1996.

(4) On or before December 28, 1998, VNG is directed to recalculate, using the rates being established by this Order, each bill it rendered that used, in whole or in part, the interim rates being replaced by the rates established by this Order. In each instance where application of the rates being established by this Order yields a reduced bill to the customer, the Company is

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<sup>4</sup> Commonwealth of Virginia, At the relation of the State Corporation Commission, Ex Parte: In the matter of adopting certain amendments to the Rules Governing Utility Rate Increase Applications, Case No. PUE850022, 1985 S.C.C. Ann. Rept. 478 (hereafter "Rate Case Rules").

<sup>5</sup> See Application of Virginia Electric and Power Co., For an increase in base rates, Case No. PUE880014, 1988 S.C.C. Ann. Rept. 312 at 313-314.

directed to refund, with interest as directed below, the difference.

(5) Interest upon the ordered refunds shall be computed from the date payment of each monthly bill was due during the interim period until the date refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's Selected Interest Rates ("Selected Interest Rates") (Statistical Release G.13), for the three months of the preceding calendar quarter.

(6) The interest required to be paid herein shall be compounded quarterly.

(7) The refunds ordered in Paragraph (4) above may be accomplished by credit to the appropriate customer's account for current customers (each refund category shown separately on each customer's bill). Refunds to former customers shall be made by a check to the last known address of such customers when the refund amount is \$1 or more. VNG may offset the credit or refund to the extent no dispute exists regarding the outstanding balances of its current customers or customers who are no longer on its system. To the extent that outstanding balances of such customers are disputed no offset shall be permitted for the disputed portion. The Company may retain refunds owed to former

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customers when such refund amount is less than \$1. However, VNG shall prepare and maintain a list detailing each of the former accounts for which refunds are less than \$1, and in the event such former customers contact the Company and request refunds, such refunds shall be made promptly. All unclaimed refunds shall be handled in accordance with § 55-210.6:2 of the Code of Virginia.

(8) On or before January 26, 1999, the Company shall file with the Staff a document showing that all refunds have been lawfully made pursuant to this Order and itemizing the cost of the refund and accounts charged. Such itemization of costs shall include, inter alia, computer costs, and the personnel hours, associated salaries and costs for verifying and correcting the refunds directed in this Order.

(9) The Company shall continue to separate the revenues and expenses associated with Schedule 9D-Yorktown from Schedule 9C in future cost of service studies.

(10) VNG shall study the propriety of developing a separate rate schedule for the Yorktown Generating Station in its next rate case.

(11) VNG shall separate the revenues and expenses associated with its joint use pipeline PT-1 customers as a separate rate class in its class cost of service study in its next case.

(12) VNG shall revise Rate Schedules 13 and 14, and the Actual Cost Adjustment tariff language as recommended in Staff Ex. GGF-28 at pages 18-21.

(13) VNG shall retain the target margin in the Margin Sharing Adjustment at the current level of \$2,426,787.

(14) There being nothing further to be done in this matter, this case shall be dismissed from the Commission's docket of active proceedings, and the papers filed herein made a part of the Commission's file for ended causes.